Washington State Liquor Control Board
Retail Services Business Plan

EXECUTIVE SUMMARY

In FY 2004, the Washington State Liquor Control Board will return more than $245 million in revenue to the state and local communities earned from the sale, licensing and regulation of spirituous liquor, beer and wine. This represents more than a 40 percent return on the state's $600 million annual investment in its controlled distribution system.

The WSLCB carries out a balanced mission. It protects public safety by ensuring effective licensing, enforcement, regulation and education with respect to all alcohol sold and consumed in the state. It also provides excellent customer service and increased revenue through its wholesale and retail sales operation. It is important to note that the agency's licensing and regulatory activities save the state millions of dollars annually by reducing the statewide costs of alcohol abuse.

In partnership with the State Legislature, the WSLCB has significantly strengthened its retail and wholesale operation in the last two years through a comprehensive strategic planning process. Revenue return has increased at a 6.5 annual rate since 1997, and strategies begun in the first Retail Business Plan – new store openings; store relocations; increased emphasis on customer service; better in-store shelf display and organization; improved technology – are expected to continue and improve that revenue-generation trend.

The 161 state and 154 contract liquor stores serve hundreds of thousands of retail customers annually and conduct a thriving wholesale business with a growing number of restaurants, clubs and other establishments licensed to sell liquor by the drink

The retail and wholesale operation is composed of three principal divisions: *Retail Services, Purchasing Services and the Distribution Center*. To develop a successful Retail Business Plan, these divisions worked closely to identify a set of targets to improve operational efficiency and increase sales. They also worked closely with producers and distributors to gain valuable input and assistance while making needed changes. These improvements focus on establishing best business practices.

The Retail Business Plan that follows represents a commitment to continuing quality improvement by the WSLCB, a more strategic, focused and targeted commitment than those previously attempted by the agency. This commitment is based to a great extent on developing and implementing new analytical models to govern the purchasing, distribution and sale of spirits. Successful retail and wholesale businesses today must follow market trends closely to adapt to changes in consumer buying patterns and to take advantage of new product development. Population growth data plays an important role in the decision-making processes used to develop and relocate stores.

If the WSLCB continues to increase revenue at annual rate of six percent during the next decade, more than $3 billion will be returned to the state. However, if the agency can return revenue at an eight percent annual rate, that total will grow to $4 billion, equal to all the revenue the agency has returned to the state in the last 70 years. This plan outlines the types of investments that are needed now to advance the strategic growth of agency revenues: investments in new stores, store relocations, infrastructure, technology and employee training

The following plan calls for continuing, measurable improvement in all basic business practices and outlines a strategy to meet growth in demand for alcohol products in a safe, orderly and sustainable manner. Plan highlights follow:

Supporting Frameworks - Infrastructure

To maintain and improve its retail and wholesale operations the agency must continue to invest in technology improvement. Managing a statewide retail and wholesale network of 315 state and contract stores presents a unique challenge in today's customer-driven market. The agency needs to improve the exchange of information among its stores and with headquarters and the Distribution Center.

Currently, stores are linked to the agency's main computer network through analog phone dial-up, technology abandoned by the retail industry years ago. Slow credit-card processing is the rule, not the exception. Critical inventory and risk management processes are being impeded. Payroll operations and general communication are hindered. Many stores have only one phone line, further impeding communication. A **Wide Area Network** is needed to speed the transfer of vital information and to meet the state requirement for improved online services.

Retail and Wholesale Revenue Enhancement Opportunities

Bottle Cont.

Retail and wholesale revenue can be increased 1) by continuing to develop new stores; 2) by relocating under-performing stores; and 3) by improving store efficiency. New stores in high-growth areas can take advantage of market opportunities not being tapped. Relocating under-performing stores (sometimes to new communities) also increases revenue potential. A more targeted and customer-friendly merchandising plan also can increase store performance.

Merchandising

Customer buying habits are continually changing and customers are increasingly demanding about the types of brands and service offered in state stores. Consumption trends are being monitored more closely to create a more targeted, strategic purchasing and supply chain for the stores. A research-based merchandising program manager is needed to capitalize on these new strategies. Focus on this critical need will help the agency develop improved in-store merchandising strategies and improved shelf management systems, which will result in increased sales and revenues.

Distribution

The new Seattle Distribution Center began operation in April 2002 with a fully automated material handling system. The material handling system is meeting its off-peak season daily shipping demands but is already at its design capacity. If improvements are not made now, the DC will be unable to handle the total volume of product needed to serve the wholesale and retail operation.

Labor needs associated with operating and maintaining this system due to increasing shipping demands, particularly during the holiday season, are an issue and are being addressed through a decision package request for the 2005-07 biennium.
Having a reliable and responsive distribution system is essential to the success of the overall operation. As such, several strategies are outlined in this plan to support this goal.

Customer Service

The cornerstone of any successful retail organization is customer service. Customers expect and demand responsive, knowledgeable sales personnel who keep current on the latest industry trends and who have in-depth product knowledge. Well-trained and well-coached employees are the key to improved customer relations. Employee training produces a direct return on investment through increased sales. In today's demanding retail environment, training is not an option; it is a necessity.

Conclusion

To implement all of the proposals presented in this plan, a substantial investment is needed. The estimated return in increased revenue through Fiscal Years 05-07 as well as beyond will more than offset the investment. In addition, other proposals and strategies will continue to be evaluated. This Retail Business Plan will continue to be reviewed and will evolve as the environment changes and as more or new information becomes available. At a minimum, the LCB will review this plan quarterly and update the plan annually.

CHAPTER 1: BUSINESS DESCRIPTION

History

Over the last 70 years, the Washington State Liquor Control Board (LCB) has provided more than $4 billion to state and local budgets through the sale and distribution of alcohol beverages. In FY 2003, the LCB distributed over $224 million to state and local governments from profits, taxes, and license fees imposed on the sale of spirits, wine, and beer. In FY 2004, that amount is expected to exceed $245 million.

The LCB has a long history as a revenue generator for the state. In 1933, after 12 years of prohibition, the 21st Amendment to the U.S. Constitution ended prohibition and provided states complete authority to regulate the distribution and sale of liquor. That same year the Washington State legislature passed the Steele Act, creating the Liquor Control Board. Under the Steele Act, tight control of liquor distribution was established through state ownership of liquor stores and strict regulation of privately owned restaurants, stores, and dispensaries that sell beer and wine.

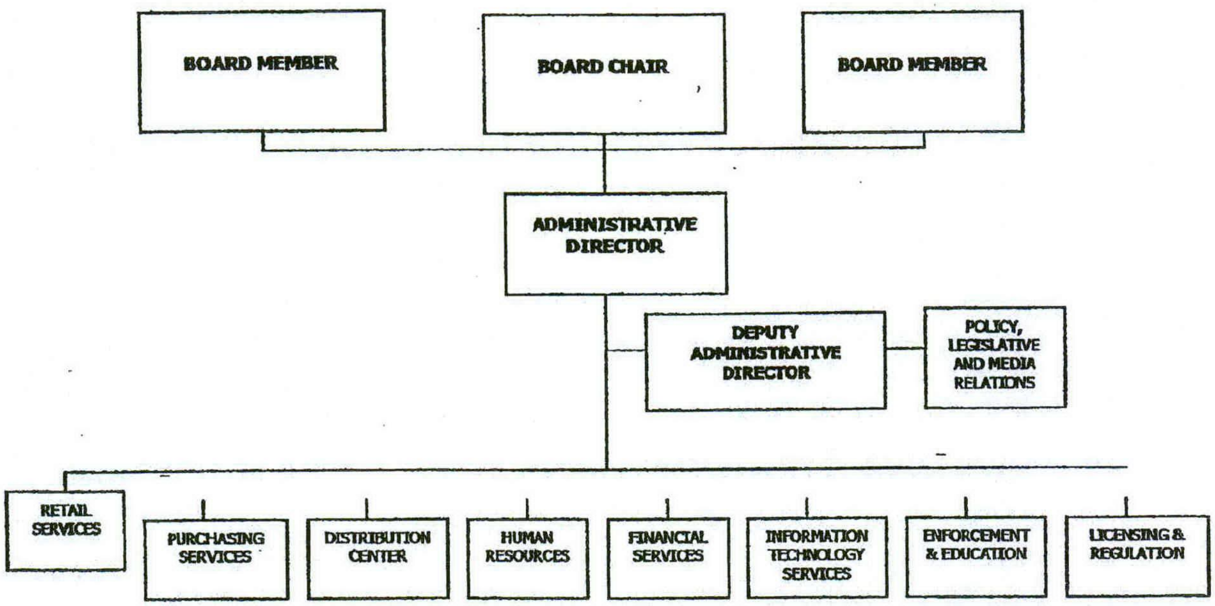
By the end of 1934, the Liquor Control Board had 46 state-operated stores and 105 contract liquor stores. Over 6,400 retailers were licensed to sell beer and wine. Today, Washington has 161 state-run stores, 154 contract liquor stores, and more than 13,000 liquor-licensed premises throughout the state.

There are 19 states with alcohol control systems. One state, Maryland, has a control jurisdiction rather than a statewide system. All but five of these states control retail sales, collecting taxes and profits from the sale of liquor. None of these states has abandoned its control system since Prohibition ended.

The LCB is administered by a three-member Board appointed by the Governor and confirmed by the Senate for six-year staggered terms. An Administrative Director manages the daily operations of the agency. The following three divisions are responsible for the retail and wholesale operation. These combined operations are the focus of this business plan:

1. Retail Services
2. Purchasing Services
3. Distribution Center

The agency organization chart follows.



LCB Mission Statement

The mission of the Liquor Control Board is to serve the public by preventing the misuse of alcohol and tobacco through controlled distribution, enforcement, and education; and provide excellent customer service by operating efficient, convenient, profitable retail stores.

Retail Mission Statement

The mission of Retail Services is to provide an outstanding retail-oriented marketing and distribution system, promote responsibility in the use of alcohol, and generate revenue to support essential public services.

Strategic Goals

The LCB has also developed the following strategic goals:

(1) Maximize revenues to the citizens of Washington.

(2) Enhance public safety by enforcing liquor and tobacco laws.

(3) Educate the public about the LCB mission and contributions to the community.

(4) Recruit, develop, retain and value a high quality diverse workforce.

(5) Modernize existing business systems and improve service delivery.

Business Plan Development

The Retail Services Business Plan has been developed to support the WSLCB's mission and strategic goals/objectives/strategies. This Business Plan is a guidebook for the agency's retail operations and progress reviews. Course corrections will be made to this plan as circumstances change, or as more or different information becomes available. This is an evolving document and will be reported against quarterly and updated annually, consistent with the agency's review and update of its strategic plan.

> The Business Plan is a guidebook for the agency's retail operations and progress reviews.

Teams of agency employees from all levels of the organization worked on the development of this plan to ensure a broad representation of experience and expertise. These teams focused on strategies with the greatest potential to create rapid, positive change in the retail operation by emphasizing best business practices and providing high-quality customer service, whether in state or contract stores. In addition, input on the components of this plan was sought from the agency's Business Advisory Council and from other stakeholders.

Milestones

The LCB and its Retail Services Division strive to maximize the return on investment to taxpayers and provide quality customer service. During the last 10 years, the agency has achieved the following milestones:

- 1994 Special Order Program by store managers initiated
- 1995 Contract store managers no longer considered state employees
- 1996 Wine Program introduced
- 1997 Agency Website launched
- 1997 Credit/debit card program implemented
- 1998 Enhanced technology & communications within agency launched
- 1999 Deloitte and Touche produce study of LCB's retail operations
- 1999 Washington State University's customer survey completed
- 2000 Governor's Retail Task Force established, submitted final report in December, 2000
- 2001 Wholesale-only outlet opened in Seattle

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- 2000-02 Significant agency reorganization:
  - 2000--Administrative Director position created to direct daily agency operations
  - 2002--Board Members reduce working hours to 60 percent
  - 2002--Business Advisory Council formed
- 2002 New Distribution Center opens
- 2002 New Retail Services Director hired
- 2003 Board direction changes to focus on policy-making and assigns responsibility for daily operations to the Administrative Director

The information garnered from previous reviews and plans is incorporated into this plan. In many cases the above milestones represent the implementation of recommendations from past plans or reviews. This Retail Services Business Plan presents a guidebook for the next biennium and beyond based on best business practices and the practical and well-seasoned knowledge of experts in the industry.

Chapter 2: MARKET ANALYSIS

This chapter discusses marketplace trends and their effect on WSLCB retail and wholesale operations. Proposals and ideas presented in subsequent chapters have been evaluated against, and are consistent with, the historical and projected trends and customer demographics summarized in this chapter.

Topics covered include:

- Sales Forecast
- Consumption Trends
- Product Trends
- Drinking Age Population Increases While Number of Liquor Stores Decline
- Distribution Strategy
- How WSLCB's Performance Ranks With Others
- Profits and Tax Collections Increase
- What Are the WSLCB's Opportunities?
- What Are the WSLCB's Challenges?
- The Future

Important conclusions regarding this information:

- Sales increases are being driven by growth in the drinking-age population.
- Insufficient agency resources exist to keep up with the growth in demand.
- A more discerning customer base wants improved product choice and increasing numbers of up-scale products.

Sales Forecast

The forecast of demand for liquor (spirits, wine, malt beverages and industrial alcohol) through state and contract stores is affected by the price of liquor, the economic situation, social trends, and the drinking-age population. Through the years these variables have changed their degree of influence on liquor sales.

The chart on the next page depicts an increase in liter sales between 1996 and 2004 from 30,000 to 37,000, a growth of over 23 percent. The projections for 2011 show a growth of 40 percent compared with 1996. In contrast, the number of Retail and Distribution Center employees has decreased by about 2 percent.

- **Price of liquor:** This played a larger role in the 1980's when the price of liquor increased sharply due to large increases in the federal excise tax and in Washington State spirit taxes. Recently, liquor prices have played a minor role due to relative small price increases and the fact that spirits are inelastic.

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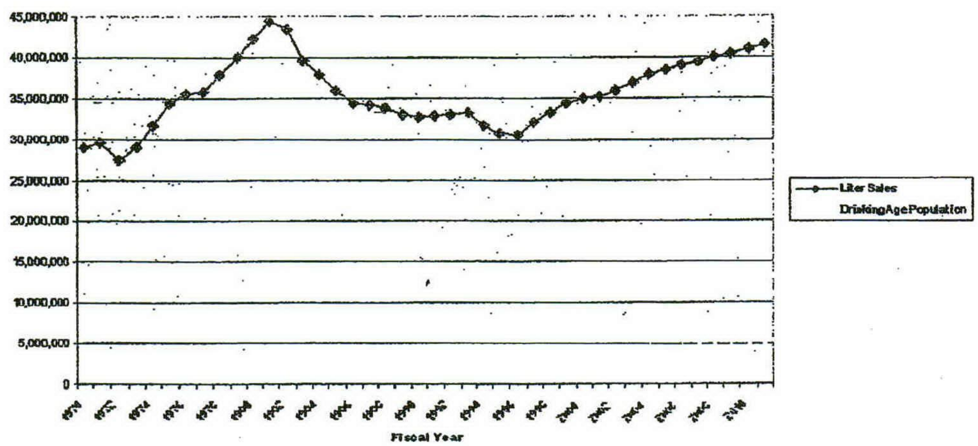
- **Economic situation:** Since 1960, only twice has there been a decrease in sales during an economic downturn. This occurred in 1970 and again in 1982.

- **Social preferences.** These played a major role from 1983 to 1996. During this period the drinking population consumed less liquor because of health concerns and stronger DUI laws.

- **Drinking-age population.** Except for the period 1983 to 1996, growth in the drinking-age population has been the primary driver in liquor sales growth. The drinking-age population is expected to increase 11 percent over the period 2004 to 2011, from 4,376,123 to 4,868,568.

Liter Sales & Population Growth 1970-2011



Consumption Trends

Nationally, consumer demand for products with flavor and style drove U.S. spirits and wine case-sales in 2003 to heights not seen in more than a decade.[1] Despite a slight dip in beer consumption, all three segments of the business posted record retail dollar sales. "Growth in beverage alcohol sales continues to be driven by flavorful and high-end spirit products, continued interest in varietal wines and the ongoing popularity of imported brews," according to the Adams Handbook. Spirit sales climbed 3.8 percent in 2003 reaching more than 159 million 9-liter cases. Wine consumption climbed 4.9 percent to the highest levels since the 1980s. And despite a slight dip in beer case sales overall, imports, lights and domestic super premium offerings continued their upward climb. Total beer consumption fell 0.6 percent to 2.8 billion 2.25-gallon cases last year.

"Consumers spent $8 billion more on spirits, wine and beer products last year compared with the previous 12 months," Adams reported. Total beverage alcohol retail dollars

[1] Adams Handbook Advance published by Adams Beverage Group

grew at a faster pace than case sales in 2003. Retail dollars climbed 6 percent to $145.4 billion, whereas overall industry case sales were essentially unchanged. "Imported products in all three segments of the beverage alcohol market grew at twice the clip compared with domestics. As with virtually every other consumer goods category, beverage alcohol continues to benefit from the trading up trend."

Many beverage analysts believe the trend toward higher-end, flavored spirits will continue in the next decade, adding to revenue growth for the state. Washington State mirrors these beverage alcohol consumption trends. In FY 2003:

- Spirit sales rose $24.5 million or 5 percent.
- Spirit case sales rose 3.1 percent.
- Spirit liter sales rose 2.7 percent.
- Wine sales rose $800,000 or 2.1 percent.
- Wine case sales rose 2.1 percent.
- Wine liter sales rose 2.5 percent.
- Case sales in the flavored vodka and rum categories growing at 26.5 and 12.3 percent, respectively.
- Consumers were "trading up," or making purchases in the higher price ranges of almost every beverage alcohol category.

Product Trends

Some products are experiencing growth while others are flat or declining in market share. For example, although beer is the most popular alcohol beverage in the country, it is losing market share to wine. On the other hand, consumption of hard liquor, which had been flat (except for some premium brands), is now enjoying growth driven by innovative new product introductions and an increase in the drinking-age population.

Washington State liquor store trends are fairly consistent with national trends. However, Washington consumers' preference for wine tends to be higher than it is nationally, while it tends to be somewhat lower for beer.

Nearly 40 percent of drinking-age adults purchase wine. Continued reports of the health benefits of red wine have helped to make it the most popular type (purchased by 24 percent of adults), closely followed by white wine (purchased by 22 percent). About 20 percent of U.S. wine buyers will spend $5 to $9 for a bottle of wine and another 20 percent will pay from $10 to $14. Washington consumers are more likely to spend $5 to $9; Seattle wine buyers are more likely than average to pay $10 to $14.[2]

The state's product line includes spirits, wines, malt beverages and industrial alcohol. For fiscal year 2003, spirit sales were $517 million, wine sales were $39 million, malt beverages were $814,000 and industrial alcohol was $350,000. In equivalent liter units, spirits are 81 percent of our business, wine is 17 percent of our business, and malt beverages and industrial alcohol are 2 percent.

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[2] Scarborough Research, 2003

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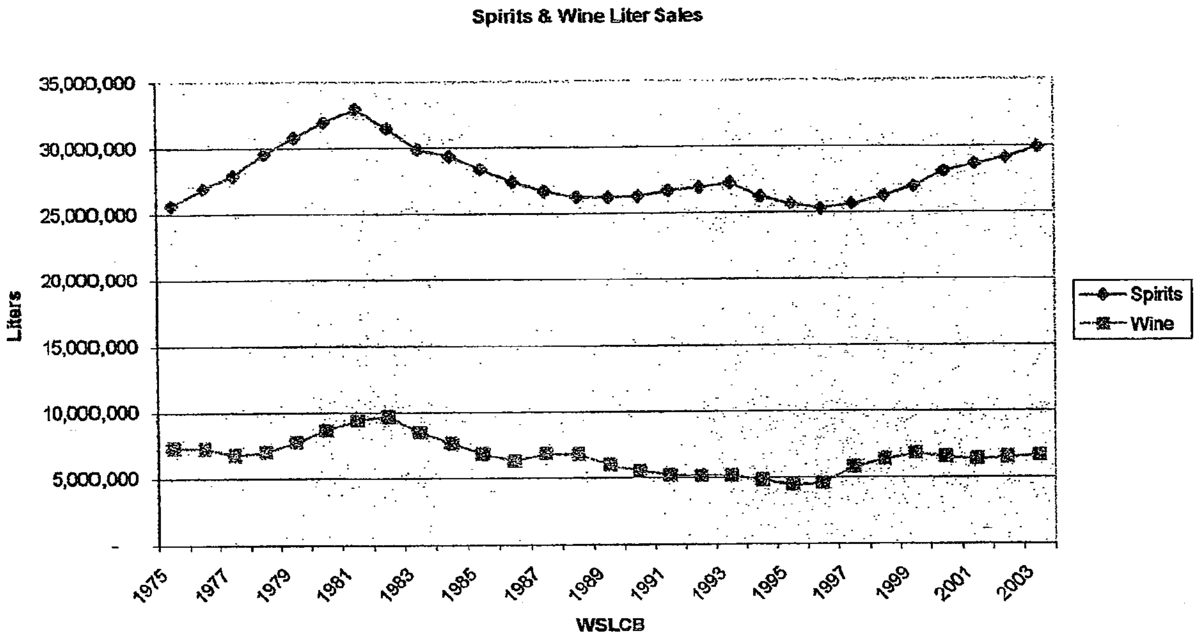
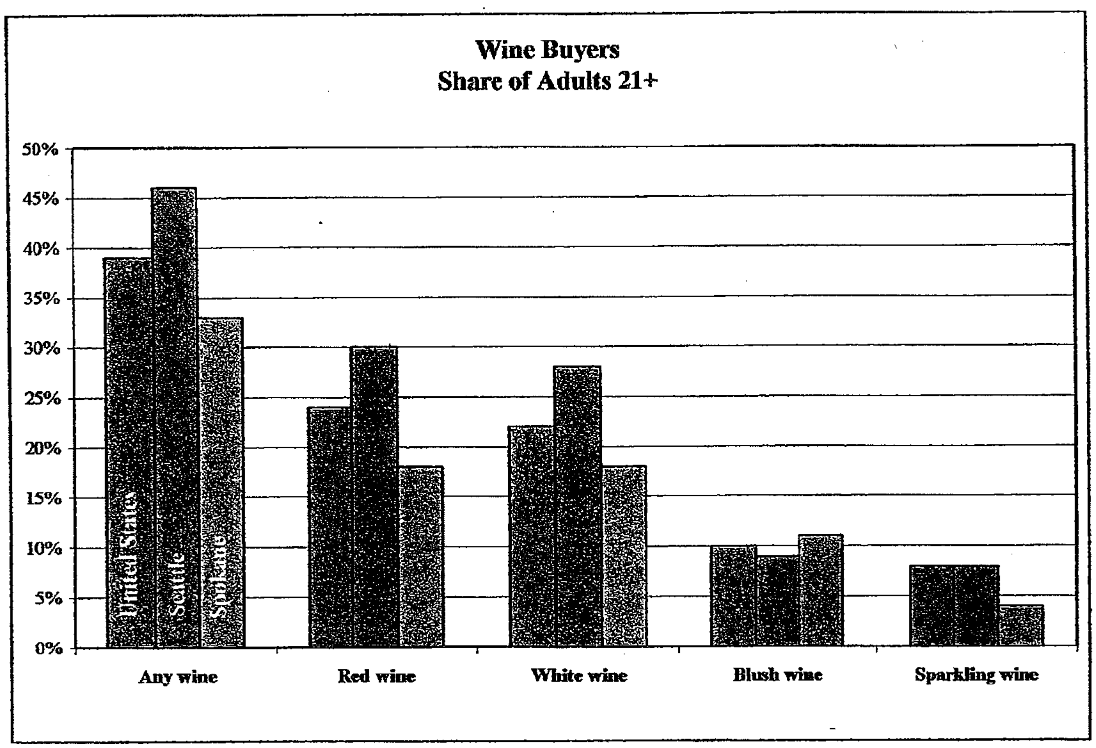


Spirits & Wine Liter Sales
35,000,000
30,000,000
25,000,000
20,000,000
15,000,000
10,000,000
5,000,000
-
Liters
Spirits
Wine
1975
1977
1979
1981
1983
1985
1987
1989
1991
1993
1995
1997
1999
2001
2003
WSLCB



Wine Buyers
Share of Adults 21+
50%
45%
40%
35%
30%
25%
20%
15%
10%
5%
0%
United States
Seattle
Spokane
Any wine
Red wine
White wine
Blush wine
Sparkling wine

WSLCB Distilled Spirits Sales Trends

The trend of "buying up" to more expensive brands is represented in Washington liquor stores. Over the last twelve months, the highest growth category for spirit case sales is in premium products, as the table below illustrates.

	2002	2003	% Increase
Flavored Vodka	5,551	7,023	26.5
Single Malt Scotch	1,922	2,202	14.6
Flavored Rum	8,358	9,383	12.3
Liqueurs	26,837	30,002	11.8
Flavored Schnapps	5,188	5,771	11.2

Stores Decline/Drinking Population Rises

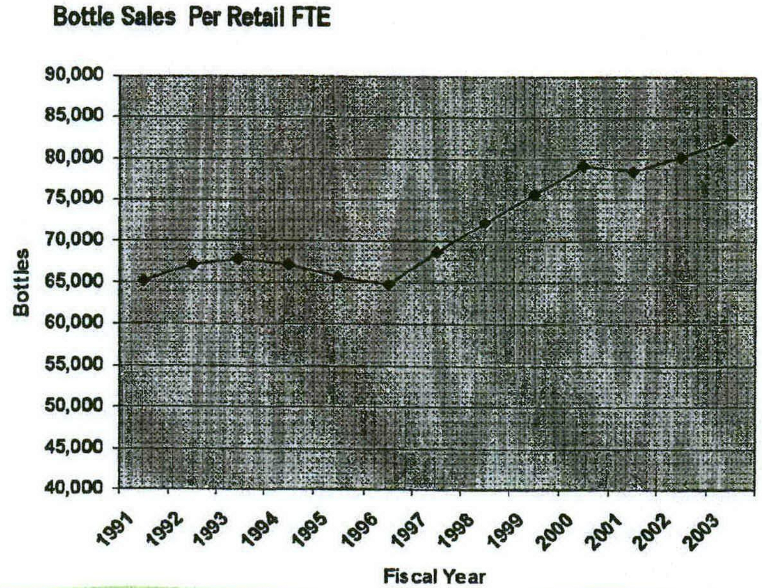
The number of LCB retail stores has not kept pace with the growth in the drinking-age population. In 1988 there were 180 state stores and 188 contract stores to serve population of 3.38 million drinking-age adults. By 2000, only 159 state stores and 157 contract stores served a drinking-age population of 4.2 million. By 2011, the number of drinking-age adults is expected to grow to nearly 4.9 million.

Additional stores were added in 2004-2005, bringing the total number of state stores to 164. The following chart also demonstrates the annual increase in the number of private licensees served by state-run and contract liquor stores.

	1980	1990	2005	2006	2007	2008	2009	2010	2011
Eligible Drinking Age Population	2,759,552	3,387,546	4,439,465	4,507,827	4,577,979	4,647,076	4,718,589	4,791,975	4,868,568
Licensees Served by LCB	2,279	2,673	4,146	4,212	4,280	4,348	4,418	4,488	4,560
State Stores	173	171	161	163	165	167	169	171	173
Contract Stores	182	176	156	156	156	156	156	156	156

As our population continues to mature, customer accessibility and convenience will become even larger factors in the operation's ability to be responsive to customer expectations. These trends, combined with the state's continued population growth, mean that careful selection of new outlet locations and models will also be important to maintain market penetration levels and maximize revenue generating opportunities.

There has been no increase in the number of retail FTEs in the last 10 years. During this period, bottle sales per retail FTE have increased 23 percent, from 67,000 per year to 82,000 per year. To achieve this result, retail operations have had to severely reduce training opportunities for employees. Formal and informal training programs have been cut to allow employees time to perform the basic store tasks such as stocking shelves and ringing sales. Similarly there is no time to talk with customers about new products and wine selections.



Population growth provides an opportunity for revenue growth and a responsibility to meet un-stimulated demand. The 1999 Deloitte & Touche Retail Business Plan reported that the number of Washington State liquor outlets per 100,000 people was significantly lower than the U.S. average, and lower than the average in most other control states. Population growth is particularly problematic in the higher-growth counties. The following table displays some areas that appear to be under-served.

Projected Population Growth --Top Ten Counties in Washington State

	State Stores	Contract Stores	Total Liquor Stores 2004	2005 Population	Population per Store 2005	2010 Population	Population per Store 2010 (if no new stores)	Persons per Sq. Mile(2000)
King	58	7	65	1,851,128	28,479	1,961,538	30,178	817
Snohomish	16	4	20	699,238	34,962	781,806	39,090	290
Pierce	19	10	29	791,400	27,290	856,004	29,517	418
Clark	5	6	11	413,273	37,570	465,996	42,363	550
Spokane	9	12	21	469,958	22,379	509,327	24,254	237
Thurston	4	4	8	255,703	31,963	287,919	35,990	285
Kitsap	6	2	8	277,242	34,655	306,960	38,370	586
Whatcom	5	6	11	194,449	17,677	217,009	19,728	79
Yakima	3	7	10	237,411	23,741	255,599	25,560	52
Benton	3	2	5	164,553	32,911	180,423	36,085	84
Skagit	4	4	8	121,451	15,181	137,054	17,132	59
Cowlitz	3	3	6	108,369	18,062	122,416	20,403	82

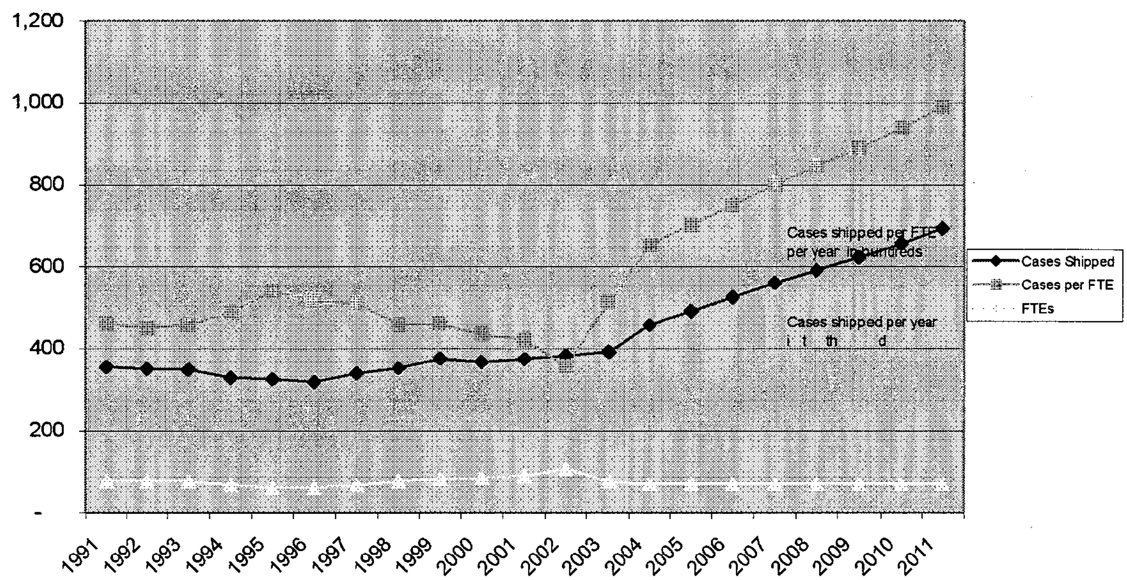
Note: Contract Stores generally serve rural populations.

Distribution Strategy

The WSLCB distributes spirits and wine to its more than 310 state and contract stores from a central warehouse in Seattle, Washington. Designed for a maximum daily shipping volume of 17,500 cases, the warehouse is nearing its capacity during peak shipping periods. Shipping volumes are expected to exceed capacity by FY 2005, outstripping both equipment and labor resources. The chart below shows the trend in cases shipped with projections to 2011.

It is important to note in viewing the chart below that the number of FTEs for Fiscal Years 1998-2002 are higher than the other years because during this period the new Distribution Center was being constructed and the agency was actually operating two separate warehouses. If these years are not included, the number of FTEs have either declined or remained constant while the number of cases shipped has continued to increase.

CASES SHIPPED VERSUS FTEs 1991-2011



How WSLCB's Performance Ranks

Other LCB results favorably compare to the private liquor industry and other private retail operations in a number of categories, as the following chart indicates.

SAME OR BETTER	INDUSTRY COMPARISONS
✓	Washington ranked third among all control states in FY 2003 in sales and revenue contributions.
✓	Average per-store net income was 8.8 percent in FY 2002. Private liquor stores report averages of between 2.1 to 2.8 percent.[1]
✓	Sales per FTE of $664,000 (2002) were higher than other control states and much greater than many retail businesses. Private liquor stores report sales of $174,000 per person.[2]
✓	LCB's inventory turns were 10.4 in FY 2004 compared to industry averages of 6.3 to 7.7 for private liquor stores.[3]
✓	Order fill rates match the industry average of 95 percent.[4]
✓	Average per-square-foot sales in state stores of $606 (2002) exceed many retail businesses. For example, Wal-Mart is $422, Costco is $771, and Safeway is $443.[5]

Retail Services management continues to develop ways to improve profitability and create efficiencies while providing high-quality customer service. The Washington State University Customer Survey completed in 1999 showed this goal is being met, as overall customer satisfaction with state liquor stores ranked high. Specific questions about customer service, product availability, location, convenience, and safety all scored consistently high.

Rising Profits/Tax Collections

Consistent with sales growth, there also has been growth in the amount of taxes collected and profits generated and distributed to the state general fund, local governments, and health care funds. Between 1994 and 2003, there was a 37 percent increase in distribution. The chart below shows the taxes and revenue distribution for Fiscal Years 1994 through 2003.

[1] Bizstats.com/liquor.htm
[2] Ibid.
[3] Ibid.
[4] Deloitte & Touche, LLP, *Washington State Liquor Control Board, Retail Business Plan Final Report,* December 1999
[5] Ibid.

DISTRIBUTION OF REVENUE (Millions of $)

	1994	1995	1996	1997	1998	1999	2002	2001	2002	2003
Cities	27.0	25.7	25.5	26.2	30.3	31.0	29.6	33.0	34.0	35.7
Counties	6.8	6.4	6.4	6.6	7.2	7.4	7.1	8.2	8.5	9.0
State	99.9	96.8	95.9	98.5	100.7	101.7	107.9	113.9	117.1	121.6
Border Cities and Counties	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.3
DSHS	4.7	5.2	5.4	5.4	5.2	5.3	5.3	5.6	5.8	6.1
SPI	0.2	0.2	0.2	0.1	0.1	0.1	0.2	0.2	0.2	0.2
Drug Enforcement	11.4	9.9	9.7	9.6	10.1	11.8	10.4	10.2	10.7	11.0
Health Care	11.8	11.6	20.3	20.7	29.2	37.6	35.8	35.3	37.6	38.7
Universities	0.7	0.8	0.8	0.9	0.8	0.9	0.7	0.6	0.8	0.8
Rapid Transit	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.3
Wine Commission	0.3	0.3	0.3	0.3	0.3	0.3	0.5	0.5	0.5	0.4
Youth Tobacco Prevention									0.1	0.1
WSP Toxicology									0.2	0.2
Total	163.0	157.1	164.7	168.5	184.2	196.5	197.9	207.9	215.9	224.4

Note: For Tax Distribution for Cities and Counties, see Appendix.

The Opportunities

Changes in the liquor industry and in market trends provide Retail Services number of opportunities.

- The LCB's new Strategic Plan and Retail Services Business Plan will provide solid direction for the agency's retail operations.
- Partnering with key stakeholders, as was done with the shelf reset program, can yield additional revenue with minimal cost.
- The LCB buys the majority of its product as bailment inventory, which means the product is not paid for until it is shipped from the Distribution Center.
- The Bailment system allows expansion of inventory in the distribution center to support store growth without additional investment in inventory.

The LCB's new Strategic Plan and Retail Services Business Plan will provide solid direction for the agency's retail operations.

- Newly installed point-of-sale equipment will provide a strong foundation to improve customer service and sales.

- Improvements in employee safety, employee recognition, and inventory management are planned.

- Growth in the drinking-age population provides opportunities for additional revenue.

- The LCB has a monopoly on spirit sales in the state.

- The new LCB management team is focused on making the Retail Services operation a leader in the industry, and to continually evaluate and review opportunities for new improvements. Areas being focused on include:
  - Developing performance standards for stores;
  - Using transaction data to develop, purchase, merchandise, monitor and ship product more efficiently;
  - Developing store location and leasing strategies using best business practices;
  - Hiring people with the skills needed to implement the business plan; and
  - Creating management tools, reporting mechanisms and risk management processes.

The Challenges

While the LCB has many opportunities to build on, there are also significant constraints that limit the potential of the Retail Services operations. These include, but are not limited to, the following:

- Increased sales volumes coupled with no store employee FTE increases have left the WSLCB unable to spare the time needed for store employee training.
- Training store employees carries a double cost in salaries and benefits as additional staffing must be provided to continue operations uninterrupted.
- The management ratio in the Retail Division is 12 WMS positions for 700 people. Consequently, management resources are stretched.
- There is not a funding process permitting reinvestment of revenue into the business, as would take place in an enterprise organization or private business.
- The agency is operating with outdated technology.
- Store employees frequently work alone in stores, increasing risk to their personal safety.
- A change in organizational culture must occur before best business practices can be fully integrated.
- The LCB has marketing and advertising limitations unlike other businesses.

- The Legislative appropriation process impedes the agency's ability to make needed investments and respond to changing market conditions in a timely manner.
- The Distribution Center is operating at or near peak capacity during high-volume sales periods. In two years, the DC will not be able to handle peak loads. The cost of labor to maintain the material management system is increasing.

The Future

The LCB's Retail Services is looking forward to continuing to create systems, efficiencies, and programs as a standard bearer in the industry. Specific plans for how this will be accomplished are outlined in this business plan. This plan will be reviewed and, as appropriate, revised as more information is available or as environmental conditions change.

CHAPTER 3: OPERATIONS

Overview

The retail and wholesale operation provides an important revenue source for the state. In FY 04 more than $600 million in annual gross sales, licensing fees and producer taxes will be collected. More than 40 percent of that amount ($245 million) will be returned to the state, cities and counties. This distribution is made *after* the cost to operate the agency has been deducted.

More than 40 percent of $600 million in revenue collected in FY 04 will be returned to the state, cities and counties.

The state is the sole wholesaler and retailer of spirits through its state and contract liquor stores. Beer and wine are sold under a "three-tiered" system designed to create a stable market and discourage over-consumption. Under this system, producers sell to distributors who then sell to retailers at a mandatory 10 percent markup. All restaurants, clubs and businesses licensed to sell liquor by the drink must obtain their spirits through one of the 161 state stores. All packaged liquor sold at retail must be dispensed through a state or contract store.

Retail Services, Purchasing Services, and the Distribution Center have 690 budgeted FTEs. As stated in Chapter 2, the collective efforts of these divisions produce results that meet or exceed some private industry and other control state system results. There are a number of reasons for this success, including:

- A monopoly on spirit sales
- Seasoned employees that are experts in the industry
- A bailment inventory system that allows the agency's Distribution Center to hold a large percentage of its inventory and not pay for product until it is shipped out to stores
- The amount of taxes collected on sales
- Good relationships with stakeholders and suppliers
- Centralized distribution system
- Lean staffing at state-operated stores
- Commission formula for contract stores
- The margins and large-scale of the operations

Consistent with the agency's strategic goals, management continues to look for ways to increase the bottom line while maintaining high-quality customer service. In preparing this plan, teams of agency employees were asked to look for opportunities to improve business operations in the following areas:

1. Create revenue enhancement opportunities and best practices in retail operations by identifying sales growth opportunities, expense savings opportunities, or some combination of both for retail operations.

2. Create revenue enhancement opportunities and best practices in wholesale operations by identifying sales growth opportunities, expense savings opportunities, or some combination of both for wholesale operations.

3. Improve distribution and purchasing, with particular emphasis on how to favorably impact the Cost of Goods Sold.

4. Improve customer service and store presentation, with emphasis on in-store merchandising, design strategies and employee training programs.

5. Improve management tools and technology, with employees identifying management systems, reporting, quality control or corrective action tools for system improvements.

This business plan incorporates the best ideas and opportunities developed through the collective efforts of LCB staff, stakeholders, and other experts in the industry.

Retail Operations

A continuing key goal is to maximize revenues by operating more like a successful business. The revenue earned through improved retail and wholesale operations helps provide a stable base for the agency to carry out its public safety mission. Improving retail sales totals while maintaining high customer service requires a focus on basic best business practices. This represents a change in orientation for store employees, who have operated without a central planning model. Basic information needed to make many decisions and evaluate the profitability of individual stores has not been available. Retailing management expertise has been lacking.

Last biennium, a new management team came on board and began exploring ways to improve retail and wholesale performance. Many improvements have been made, but many more changes are needed to create a model wholesale/retail operation.

Based on recommendations by employee committees and intensive study by management staff, the following recommendations have the greatest potential to effect improved revenues.

TX017_020

1. **<u>Relocate Six Under-Producing Stores</u>**

There are many variables to consider in making store relocations, such as the net impact such decisions have on total sales, customer service and aggregate profitability. The following steps will be taken in making these decisions:

- Establish location performance standards for state-operated and contract stores.
- Conduct a review of all stores using these standards.
- Implement relocation strategies to improve performance at the least-profitable stores.

An example of a performance evaluation standard for a state store follows:

<u>Revenue Return Ratio</u>

Revenue generated by stores comes from taxes and markup assessed on each bottle sold. One way to gauge the success of a store is measure the store's aggregate sales against taxes collected, as shown in the diagram below.

$$\frac{\text{Taxes collected plus net profit or minus losses}}{\text{Sales for reporting period}} \quad \textit{(divided by)}$$

The resulting ratio is an indicator of a store's revenue generation. A 25 percent return is suggested as a minimum threshold, with some consideration given to a store that has disproportionate wholesale sales volume.

An additional performance indicator could be employed to help stores achieving only the minimum 25 percent return improve:

- <u>Average sales per square foot</u>: A minimum for review would be $350 of sales per square foot. A next step would be to determine what could be done to increase this sales rate to at least $400 per square foot via training or corrective action.

- <u>Sales to FTE ratio</u>: A minimum for review would be the average store's sales divided by the FTE count. If this minimum is not met, determine what could be done to increase sales per FTE via training, merchandising or other action.

- <u>Proximity to other state-operated or contract outlets and net revenue impact</u>: Determine if any other stores are within a five- to 10-mile radius of the store under review, with consideration given to whether it is in an urban or rural location and accessibility to licensee accounts. Assuming stores within five to 10 miles of a closed store will absorb a portion of the closed store's business, estimate the net revenue loss of the closure.

The strategy for relocations is to identify high-traffic locations that have similar customer demographics that would result in higher sales and revenue return. An example would be moving into existing locations next to grocery stores, or a mall where a grocery store is an anchor tenant.

The goal in this process is to make thoughtful decisions regarding what action(s) are most appropriate to take of all the stores in aggregate, with the end goal to maximize revenues and improve customer satisfaction.

2. **Open Additional Retail Stores**
The market trend data presented in Chapter 2 indicates there are opportunities to selectively expand by opening new stores, particularly in the state's highest-growth areas. As the data indicates, fewer stores are serving more people per capita than ever. In some areas, store capacity is stretched thin, particularly during peak buying periods. To meet this additional demand and to capitalize on growth niches, three new stores and two new concept stores are proposed for the 2005-2007 biennium.

3. **Expand Store Personnel Training Program**
The WSLCB must rely on in-store merchandising to market its products. One of the most direct ways and key to the agency's business strategy is to improve store merchandising, improve product knowledge, customer service and merchandising display skills of store employees through training.

4. **FTE / Production Formula**
If new stores are not opened and FTE's not increased in our current retail outlets, each store will continue to serve increasing numbers of customers. This means the same number of employees per store will be tasked with selling an increasing amount of inventory. This will result in declining customer service and decreasing revenue.

The following primary considerations will have a negative impact on our agency, customers and stakeholders:

- **Maximizing revenue potential.** Due to insufficient hours of operation and declining levels of service, the agency's maximum revenue-generating potential may not be reached.
- **Managed growth and future potential is diminished** by not responsibly re-investing in the enterprise. The agency is capable of giving a most favorable return on investment as proven by past performance. Given this, the return on investment carried long-term will substantially out-perform other options given to government today.
- **Increased risk to employees, customers and assets.** With inadequate staffing in stores, employees may not be able to address potential safety and security needs.

5. **Pursue Reinvestment Funding Strategies**
   Working within the context of appropriated funding restricts management's ability to respond to market changes quickly and invest or re-invest resources as needed to maximize revenues to the state.

6. **Install a Wide Area Network (WAN)**
   Stores currently have only a dial-up connection for credit/debit card authorizations, email, intranet access, payroll processing, lottery scratch ticket verification, and security monitoring. Dial up connections are extremely slow in today's environment. It takes 25 to 40 seconds for credit/debit card authorization compared to the industry standard of less than 1 second. A WAN will be required to accommodate the state's new HR system being implemented in 2005.

Purchasing and Merchandising

As the Deloitte & Touche Retail Business Plan emphasized, leading retailers generally use a merchandising strategy that sets the course for product selection, ordering, product allocation to stores, store layout, and shelf and category management. The WSLCB has policies and systems for product selection, purchasing, and distribution. However, no overall merchandising strategy, shelf or category merchandising programs are in place. Purchasing Services continues to use an outdated forecasting and re-order system that does not operate on modern inventory management principals.

Successful merchandising programs can generate sales and maximize margins, particularly in a changing marketplace. Input from manufacturers suggests an effective store merchandising program can increase sales between two and three percent, although the specific success rate is difficult to prove as there are many variables that impact sales trends. Each percentage point increase in annual sales equals $5 million added to gross sales. This opportunity is supported by research that indicates the majority (66 percent) of consumer decision making occurs in the store and that today's customers make choices quickly after minimal search and price comparison. A store-merchandising program can:

Successful merchandising programs can generate sales and maximize margins, particularly in a changing marketplace. If a 3 percent increase were realized, the WSLCB's annual sales would increase by over $15,000,000.

- Promote ease of product selection
- Encourage impulse purchases
- Optimize shopper trade-ups
- Help minimize out-of-stocks
- Make product mix decisions and inventory control easier

Initiatives in this area include:

Create a Store Merchandising Program

Basic elements of a merchandising program would include:

- Optimum product selection
- Uniformity of look in state-operated stores
- Effective category and shelf management programs
- Consistency with current design concepts
- Expanded training for store teams
- Maximum use of floor and shelf space
- Consistent and effective signage
- Flexibility in fixtures
- Explore other retail store concepts

1. **Hire a Merchandising Manager**
   A Merchandising Manager is needed to direct this work and to work more closely with suppliers to ensure their viewpoints are being heard. This position is similar to the Wine Program Manager position created in 1996 to focus on the purchasing and merchandising of wine. Wine sales rose from $19 million in 1996 to more than $36 million in 2001.

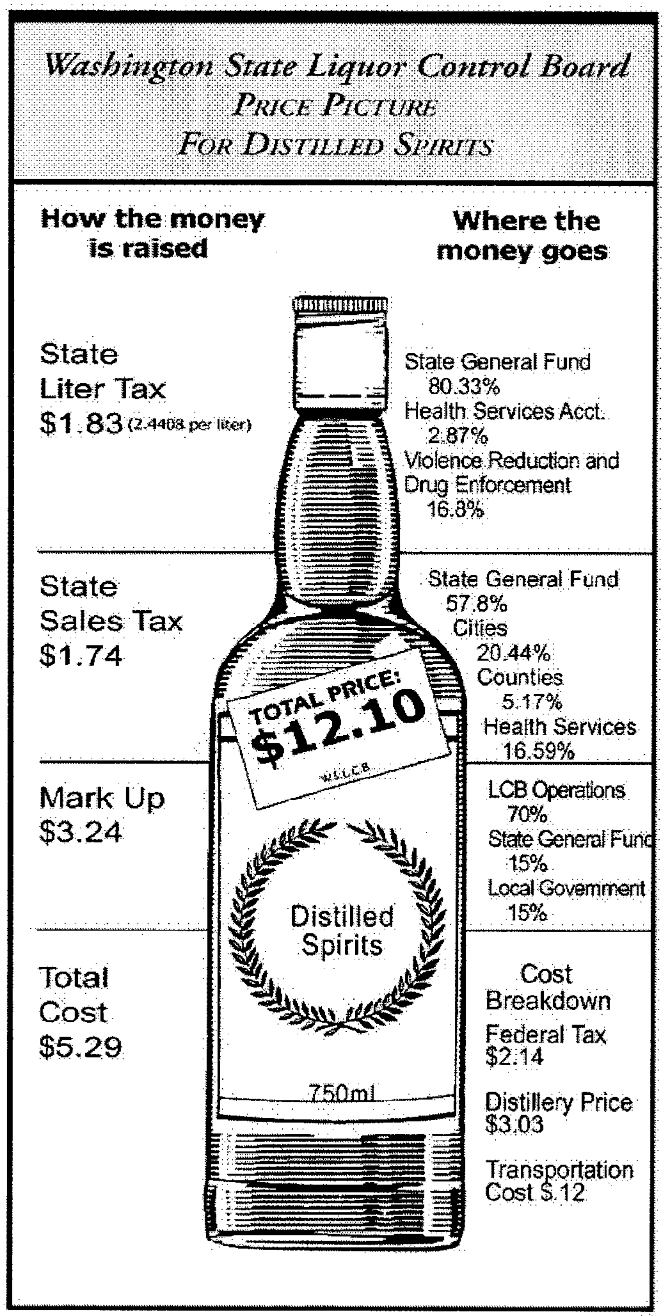
Pricing

The retail price of liquor sold in state-run and contract liquor stores is determined by five elements:

1. Distiller's, brewer's, or vintner's price to the Board
2. Federal taxes--excise tax rates on all liquor, plus custom duty rates on imported liquor
3. Freight costs
4. Markup controlled by the Board
5. State sales taxes that are set by the State Legislature

On the following page is a breakdown of how the above elements are applied to the pricing of one bottle of liquor.

TX017_024



For wholesale accounts there is a tax exemption and a standard discount. Discount rates and tax exemptions are also established for Tribes and military establishments.

For spirits, the Board approves all new product listings, and these products have twelve months to meet profitability requirements. Spirit listings are recommended to the Board by the Purchasing Services Director, using established criteria. Wine listings are recommended to the Board by the Wine

Program Manager, with input from the Wine Advisory Committee. Wines are available for general distribution to all stores or are distributed to "hub stores," which receive wines bought in smaller quantities and distribute to other stores in the area that may wish to sell these products. Existing products are reviewed annually to see if they meet the profitability standard for their product class.

The markup the Board establishes on products, and the resulting margins made on sales are the key determinants of the Cost of Goods Sold percentage. In conjunction with the goal of reducing the businesses Cost of Goods Sold, a review is being done to determine opportunities to increase margins on specific products to support the Cost of Goods Sold reduction goal.

Inventory Management

Inventory management is a key component of purchasing and merchandising. Knowing where stock is, what is in stock and out-of-stock, setting inventory levels, and managing inventory turns and special order programs all affect purchasing and merchandising decisions. The new point-of-sale system will improve this capability. During the next three years, managing inventory levels will be a third way of reducing the business's Cost of Goods Sold. Results of this effort will include the following:

1. **Increase Inventory Turns in State Liquor Stores**
   The goal is to increase inventory turns from the current 10.4 turns per year to 11.5 inventory turns per year by June 30, 2006, and to 13 inventory turns by June 30, 2007. Achieving an increase to 13 turns per year from the current 10.4 will improve working capital by $10 million.

Distribution

The mission of the agency's liquor Distribution Center is to ensure the timely, safe, and efficient receipt, storage, and shipment of spirits, wine, and beer to the 315 state-run and contract liquor stores and to tribal and military outlets located throughout the state.

As part of the agency's plan to modernize the state's liquor retail and distribution systems, the agency's original Distribution Center was replaced with a new 160,000 square-foot facility on the existing Seattle site. The WSLCB has been operating out of the new Distribution Center since April 2002 with a new automated material handling system to process the approximately 17,000 cases of liquor shipped out of the facility each day.

The Distribution Center maintains a daily inventory level of between 400,000 and 500,000 cases of liquor, depending on peak periods. The receiving department processes receipts from approximately 330 domestic and international shippers. Local freight carriers redistribute product weekly to the 315 retail outlets. Since 2001, shipments have increased from 3,748,028 to 3,925,563 cases for 2003. This is a 4.7 percent increase in volume in 3 years. The October through December 2003 holiday period reflected a 3.8 percent increase over the same time period of 2002.

Having a reliable and responsive distribution system is essential to the success of the overall operation. As such, the following strategies have been established to support this goal:

1. **Increase the Distribution Center's Capacity**
   The DC was designed in the early 1990s to meet an estimated one percent annual growth rate over a 20-year period. Real growth in bottle sales far outpaced this estimate. In 2002, when the DC opened, it already was operating near capacity during peak periods. By 2003, the agency had already achieved the 20-year growth level predicted a decade earlier. The DC's capacity is being stressed during the off-season and is seriously challenged during the holiday peak season. The agency now predicts sustained annual growth of 5 percent. The DC needs to be expanded this biennium or it will not be able to fully handle the WSLCB's product shipping and storage needs.

2. **Achieve a Fill Rate of 96 Percent of Available Product**
   To accomplish this goal going forward, the staffing at the Distribution Center needs to be modified and capacity increased. Similarly, as growth occurs, the need for spare parts increases. It is also important that the Distribution Center has spare parts readily available as existing parts break or wear out. Any downtime affects deliveries and availability of stock at stores. Because the vendor is from overseas, some parts are not readily accessible. The DC has obtained an inventory of parts to be physically located at the Distribution Center.

Customer Service

1. **Install a Wide Area Network (WAN)**
   Credit/debit card authorizations take 23 to 40 seconds to complete compared to the industry standard of less than one second. This causes lengthy delays and loss of efficiency during peak periods and holidays. These delays discourage customers from returning and leave them with a negative perception of how the state does business. Other revenue opportunities will be possible once a WAN is installed, like gift credit cards and additional lottery games, that will generate even more revenue for the state.

2. **Line Buster Technology**
   Customer throughput in our stores can be improved with Line Buster technology. Portable scanning equipment combined with our new MBS system will help reduce long lines during the holidays and have other multiple uses.